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Macroeconomic Adjustment and Growth

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Report on Adjustment Lending II

Lessons for Eastern Europe

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The countries of Eastern Europe have much to gain from stabilizing their economies and integrating them with the world economy. They should make trade reforms a high priority. Policymakers there should look at the recent economic history of other nations for lessons.

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This paper — a product of the Macroeconomic Adjustment and Growth Division, Country Economics Department — is part of a larger effort in PRE to improve the understanding of policy reforms in Eastern Europe. Copies are available free from the World Bank, 1818 H Street NW, room N11-035, Washington, DC 20433. For Bank staff, please contact Aludia Oropesa by electronic mail (41 pages, with tables).

The Bank introduced adjustment lending in 1979 to help member countries restructure their economies to create conditions conducive to equitable growth while maintaining a sustainable balance of payments. Adjustment lending sets policy reforms as conditions of a loan.

A review of the experience of other nations with adjustment problems may provide useful knowledge for Eastern Europe as the region attempts to make the transition to market economies and to integrate with the world economy.

Reforms such as those that Eastern Europe is initiating now have little precedent in recent economic history. Evidence from other countries indicates, however, that output levels are likely to suffer in the early years of massive economic restructuring. Governments must be aware of these adjustment costs, which represent an investment in a better economic system.

If they want their investment to be highly profitable, they must prepare a coherent program, hold fast to their policies, and remove impediments to factor allocation. As the credibility of the reforms increases, investment and output will respond. Recent experience in other countries suggests several constructive steps that Eastern European countries can take to ease their transition to market economies:

- Policymakers should place a high priority on dealing with high open or repressed inflation and other manifestations of severe macroeconomic imbalances such as unsustainable current account deficits or very large positive real interest rates.

- At the same time, they should remove restrictions on labor mobility and on the exit and entry of firms at the same pace as they liberalize trade. In that way, reforms can achieve an increase in output early rather than causing increasing unemployment.

- Decisionmakers should move early to create markets for working capital financing — with appropriate mechanisms to assess credit risks — in order to encourage economic restructuring. The creation of a full-fledged financial system is not urgent and should take place only after the countries have achieved economic stabilization.

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REPORT ON ADJUSTMENT LENDING II: LESSONS FOR EASTERN EUROPE

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I. INTRODUCTION

The World Bank introduced Adjustment Lending as another form of lending in 1979 to assist member countries in their adjustment to the second oil shock. The main difference between this form of lending and traditional project lending is that Adjustment Lending is quick-disbursing, and it is made conditional on policy reforms. After growing rapidly in the first half of the 1980s, Adjustment Lending leveled off in 1986-88, when it averaged 24 percent of Bank Group lending commitments. In 1989 it reached 27 percent of total lending commitments. The two principal instruments of adjustment lending are: Structural Adjustment Loans (SALs) and Sectoral Adjustment Loans (SECALs). SALs support economy-wide reforms and institutional building, while SECALs have more of a sector focus.[1]

One could ask why was adjustment lending introduced in 1979. By the late 1970s a large number of countries were having difficulties in financing their balance of payments deficits. At the same time, their growth performance was very weak. Common causes of these difficulties were many years of distortionary trade, regulatory and exchange rate policies, and an expansion of the state's role in the allocation process. Ultimately, these factors resulted in an inefficient use of resources, discouraged exports and created an internationally uncompetitive structure of production. Countries facing this type of problems were spread throughout different geographical regions, including among others, Ghana, Senegal, and Tanzania in Africa, Jamaica, Argentina, Bolivia and Turkey elsewhere. When the second oil shock hit in 1979, these economies were ill-prepared to absorb higher prices without

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[1] Both types of loans generally disburse against general imports with a small list of excluded items.

radical changes in their economic policies and institutions. As there were major gains to be obtained from reducing inefficiencies in the use of resources, in particular, from removing excessive regulation and from reducing part of the anti-export bias of their policies -- stabilization programs accompanied by reforms toward a market based allocation process could reduce the cost of the oil shock.

The main purpose of adjustment lending is to help member countries restructure their economies to create the conditions for equitable growth while maintaining a sustainable balance of payment situation. Structural adjustment programs include measures to achieve or consolidate macroeconomic stabilization and the structural transformation of the economy. Adjustment lending facilitates the phased reduction of the current account deficit while reforms are being introduced allowing the country to have a higher level of expenditures than otherwise and in this way reduces the short-run adjustment costs to output, employment and consumption. The risk of this type of lending is that while it provides financing that helps to sustain expenditure levels, it could also result in the postponement of necessary reforms. Conditionality is introduced to ensure that loan disbursement is tied to the implementation of an agreed program.

As some countries were adjusting to the second oil shock and some others were plannning the transition from financing to adjustment, they were faced with the consequences of major policy changes in the industrial countries. Following the frontal attack on inflation that most industrial countries initiated in late 1979- early 1980s, interest rates reached their highest level in 50 years, the industrial countries entered in a major recession, and primary commodity prices collapsed. To make matters even worse, following Mexico's difficulties in servicing its foreign debt in late 1982, commercial

lending to developing countries all but disappeared. Current account deficits that could be financed without much difficulties in 1981, all of a sudden could not be financed at all. For most countries the urgency of adjustment increased. In countries where large distortions and institutional weakness were preventing the economy from producing as much as it might, the removal of these distortions was seen as a less costly option than reducing the current account deficit by solely reducing expenditures. Not surprisingly, more countries had to initiate adjustment programs: Chile, South Korea, Thailand, Uruguay, Ghana, Mexico, etc..

Following these developments in the international economy, it is not surprising that adjustment lending grew rapidly in the first half of the 1980s.

A difference should be made between structural adjustment programs and adjustment lending. Countries have been implementing structural adjustment programs for a long time on their own while the Bank has been supporting countries in the preparation of and implementation of adjustment programs since at least the late 1950s. However, quick disbursing balance of payments support for adjustment programs was introduced only in 1979.

The Bank periodically evaluates the design and implementation of adjustment programs. Two recent comprehensive reviews we recently carried out by the World Bank (1988a and 1990a). The Bank also carries out a research program on economic development with heavy focus on current and prospective problems of developing countries. The findings of this research and of the research carried out elsewhere provide important underpinnings for the Bank's advice on the design of adjustment lending operations.

The rest of this paper is divided into four sections. Section 2 presents the emerging consensus on the design of adjustment programs. The

third section presents the main findings of the second report on adjustment lending on effectiveness of adjustment lending and on implementation of programs. Section 4 reviews the findings of RAL-2 on policies for the recovery of growth. Finally, Section 5 presents some lessons on program design for Eastern Europe.

II. EMERGING CONSENSUS ON PROGRAM DESIGN

From research done analyzing economic reforms in developing countries, both successful and some unsuccessful, some important lessons have emerged. These lessons have served as the basis for an emerging professional consensus on program design. Of course, the particulars of a country-specific adjustment programs need to take into account the economic and political conditions in each country.

For reforms to be successful, they should have a good chance of making important progress in removing the impediments which prevent obtaining the maximimum output from existing resources. In countries with major impediments to resource reallocation in the form of high and variable inflation, high level and high variance of tariff rates, restrictions to factor mobility, ill-defined property rights, and a large public sector sheltered from efficiency considerations, any reform effort that does not address these barriers would have a low chance of success. Furthermore, without removing these impediments, reforms will have low credibility and could unleash responses that could result in a deterioration of the economic situation instead of an improvement (Calvo, 1989).

In countries that are experiencing acute macroeconomic imbalances manifested in the form of high open or repressed inflation, large fiscal

deficits and major balance of payments crises, structural reforms should start by attacking the ultimate causes of the macroeconomic crisis (Fischer, 1986; Corbo and de Melo, 1987; Sachs, 1987; Corbo and Fischer, 1990; and Rodrik, 1990). As the success rate of stabilization programs in countries that have experienced a prolonged period of inflation is very poor, it is very dangerous to proceed simultaneously with reforms whose ultimate success depend on the control of inflation (i.e., major trade and financial liberalization). Successful stabilization attempts have included major fiscal adjustment in the form of cuts in government spending, reductions in large subsidies, reduction in public enterprises losses, and drastic reduction in central bank losses (Dornbusch, 1989; Kiguel and Liviatan, 1988). In the period immediately after the Second World War, monetary reform was used to avoid an explosion in inflation by countries that had accumulated a large money overhang during the war years (Dornbusch and Wolf, 1990). Some of these reforms to restore macroeconomic stability could require major structural reforms in the operation of public enterprises, the tax system, and the financial system in order to establish the capacity to evaluate loans on a commercial basis. In countries with a large public sector, including public enterprises with major losses and widespread government subsidies, the stabilization could require a major overhaul of the public sector (Chile, 1973-76; Mexico, 1982-89; Argentina, 1989-). Major increases in labor mobility and flexibility for the hiring and firing of labor should be introduced early on to facilitate the stabilization. Parallel programs to provide a safety net to the temporarily unemployed could increase the political acceptance and make the program more equitable.

Once enough progress has been achieved in reducing -- in a credible way -- the inflation and the balance of payments deficit, other structural reforms aimed at improving resource allocation and achieving sustainable and equitable growth should be attempted. These reforms include: public sector reforms, trade reforms, financial reforms, reforms of the regulatory framework and labor market reforms.

III. MAIN FINDINGS OF RAL-2: EFFECTIVENESS OF PROGRAMS AND PROGRAM IMPLEMENTATION[2]

For countries experiencing acute macroeconomic imbalances and which suffer from deep rooted structural problems that impede a better use of resources and limit growth, the benefits from a structural reform program will take time to develop. Therefore, to assess adequately the effectiveness of adjustment programs, enough time should be allowed to elapse since the initiation of the program before it is examined. Intermediate evaluations could rely on indicators of progress in the adjustment. That is the route followed in the Bank's two reports on Adjustment Lending (RAL-1 and RAL-2).

A. Effectiveness of Adjustment Programs--Macroeconomic Indicators

To assess the contribution of adjustment lending to sustainable growth, the second Report on Adjustment Lending (RAL-2) examines performance in terms of intermediate indicators of structural transformation--saving ratios, investment ratios, and export ratios--along with the rate of growth of output. For the analysis, countries are grouped into three categories: early

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[2] This section and the next draw heavily on World Bank (1990b).

intensive-adjustment-lending (EIAL), other adjustment lending (OAL), and non-adjustment-lending (NAL) (Table 1).[3]

The observed performance of an adjusting country results from (a) the policies that would have been in place in the absence of adjustment lending from the Bank, (b) world economic conditions, (c) the effects of a Bank-supported program, and (d) other shocks to the economy (droughts, earthquakes, etc.). To isolate the net contribution of the Bank-supported program, a counter-factual scenario was created by estimating the effects on performance of:

- External shocks (interest rate, terms of trade, non-official lending).
- The economic policies in the pre-program period (indicated by the real exchange rate, ratio of the fiscal deficit to GDP, and annual rate of inflation).

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[3] The groups of countries and periods used here are different from those of RAL - 1. Here the EIAL countries include all the intensive-adjustment-lending countries of RAL - 1 plus 13 more. Because another year of performance can be looked at, the RAL - 2 intensive adjusters include additional countries whose second or third adjustment loans came after 1985. Within each group a breakdown is made between low- and middle-income countries. Low-income countries are defined as all the IDA countries (including those receiving a blend of IDA and IBRD loans) and the middle-income countries as all the rest.

The Bank's first Report on Adjustment Lending (RAL - 1) concluded that by the end of 1987 the 30 countries receiving structural adjustment loans (SALs) before 1985 performed better on average than did the developing countries not receiving such loans. This conclusion was based on two comparisons: the performance of countries before and after receiving adjustment loans; the average performance of countries receiving adjustment loans before 1985 and of countries not receiving such loans. The 30 countries receiving loans had modest improvements in performance, despite a more unfavorable external environment, as compared with the other group of countries. The 12 countries that received 3 or more adjustment loans before 1987 had more pronounced improvements.

Table 1: Country Classification

I. EIAL (Early Intensive-Adjustment-Lending Countries)(25)

Bolivia *	Mauritius
Brazil	Mexico
Chile	Morocco
Colombia	Nigeria*
Costa Rica	Pakistan *
Côte d'Ivoire	Philippines
Ghana *	Senegal *
Jamaica	Tanzania *
Kenya *	Thailand
Korea, Rep. of	Togo *
Madagascar *	Turkey
Malawi *	Zambia *
Mauritania *	

II. OAL (Other Adjustment-Lending Countries)(25)

Argentina	Indonesia
Bangladesh *	Mali *
Burkina Faso *	Niger *
Burundi *	Panama
Central African Rep. *	Sierra Leone *
China *	Somalia *
Congo, People's Rep. of	Sudan *
Ecuador	Tunisia
Guinea *	Uruguay
Guinea-Bissau *	Yugoslavia
Guyana *	Zaire *
Honduras	Zimbabwe
Hungary	

III. NAL (Non-Adjustment-Lending Countries) (28)

Algeria (NA)	Malaysia (NN)
Benin * (NA)	Myanmar * (NA)
Botswana (NN)	Nicaragua (NA)
Cameroon (NA)	Oman (NN)
Dominican Republic (NA)	Papua New Guinea (NA)
Egypt, Arab Rep. of (NA)	Paraguay (NA)
El Salvador (NN)	Peru (NA)
Ethiopia * (NA)	Portugal (NN)
Greece (NN)	Rwanda * (NA)
Guatemala (NN)	Sri Lanka * (NA)
Haiti * (NA)	Syrian Arab Republic (NN)
India * (NN)	Trinidad and Tobago (NA)
Jordan (NA)	Venezuela (NA)
Liberia * (NA)	Yemen Arab Republic *(NN)

EIAL are countries that have received 2 SALs or 3 Adjustment Operations or more, with the first adjustment operation in 1985 or before.
OAL are other countries receiving adjustment lending.
NAL are countries that did not receive AL in the period 1980 to 1988.
Low income countries (*) are IDA countries, and middle income countries are non-IDA countries.
NA are countries that did not adjust although it was necessary for them to do so.
NN are other NAL countries.

- The initial values of the four indicators of macroeconomic adjustment -- real GDP growth and the ratios of investment, saving, and exports to GDP.

We compare the performance as measured by the four indicators in 1985-88, the period after adjustment was initiated, with performances in 1970-80 and in 1981-84. Because some countries started to receive adjustment lending in the early 1980s, the base period 1970-80 corresponds more closely to the period before adjustment lending.[4]

Before-and-after comparisons of performance indicators provide useful background for the counterfactual analysis, whose results are presented later. Although we cannot judge a program's effectiveness on the basis of before-and-after comparisons, they are likely to be important to the political viability of the adjustment programs. Before-and-after comparisons can be obtained from the data reported in Table 2.

It is possible that exogenous influences that had nothing to do with the Bank-supported adjustment programs could have led to the observed improvement in GDP growth, the saving rate, and the export rate of the EIAL countries in 1985-88, after the Bank-supported adjustment programs started. These influences include higher export prices, lower import prices, lower interest rates on external debt, and higher external financing. To assess the contribution of adjustment programs to macroeconomic performance, the actual performance of a country in the period after adjustment was initiated (1985-88) must be compared with an estimated counterfactual scenario of what

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[4] The base period 1970-80 was chosen because it preceded the major shocks of the early 1980s and is not dominated by conditions in a particular year or two. Performance in 1985-88 is also compared with that in 1981-84.

TABLE 2
COUNTRY PERFORMANCES

	Rate of Growth[1]			Domestic Saving to GDP			Investment to GDP			Ratio of Exports to GDP		
	1970-80	1981-84	1985-88	1970-80	1981-84	1985-88	1970-80	1981-84	1985-88	1970-80	1981-84	1985-88
EIAL average	4.6 (2)	1.3 (3)	4.2 (1)	17.4 (1)	14.8 (1)	17.2 (1)	22.5 (2)	19.9 (1)	18.6 (1)	24.2 (2)	25.1 (2)	28.1 (1)
-median	5.6	0.6	3.9	16.8	14.4	19.3	23.5	20.2	18.5	20.8	22.5	23.2
-1st quartil	2.5	-0.5	2.3	13.9	10.7	10.9	20.2	16.1	14.9	18.4	14.5	17.6
-3rd quartil	6.3	2.7	6.1	20.8	20.1	22.8	25.9	23.7	23.7	29.8	36.0	37.0
OAL average	3.9 (3)	2.3 (2)	3.0 (2)	14.0 (3)	12.7 (2)	13.3 (3)	21.3 (3)	22.0 (2)	20.1 (3)	22.2 (3)	24.4 (3)	23.6 (3)
-median	3.6	1.9	3.3	14.2	12.1	13.6	21.7	19.4	18.4	19.1	22.3	22.3
-1st quartil	2.7	0.6	1.2	4.7	1.3	4.1	15.0	15.3	13.8	12.8	12.6	12.5
-3rd quartil	4.9	3.9	3.8	21.6	21.6	20.7	26.9	26.7	24.9	28.8	27.9	32.2
NAL average	5.5 (1)	3.1 (1)	2.7 (3)	16.7 (2)	14.0 (3)	14.4 (2)	23.4 (1)	24.1 (3)	20.0 (2)	26.3 (1)	26.1 (1)	24.6 (2)
-median	4.6	2.7	2.2	16.2	14.1	12.2	22.3	23.5	20.0	23.2	24.2	20.8
-1st quartil	3.6	-0.7	0.8	11.0	5.2	6.2	18.5	18.1	13.6	15.4	13.8	12.1
-3rd quartil	7.0	5.7	4.1	20.1	21.1	21.3	27.9	28.0	24.2	32.1	31.1	34.6

Source: World Bank Data

(1) The rate of growth is calculated with data in constant local currency.
The ratios are calculated with data in current local currency.
Figures in parenthesis indicate the ranking for the respective variable. A (1) indicates the best performance for the respective policy indicator.

would have happened in that period in the absence of a program but with the same exogenous influences.

The results are shown in Table 3. After explicitly adjusting for the external shocks, initial conditions, levels of external financing, and policies followed in the pre-program period, the change in the annual average rate of GDP growth in the EIAL countries was higher but not statistically different from that of all the other countries when measuring changes between 1970-80 and 1985-88. Between 1981-84 and 1985-88, however, adjustment programs are estimated to have boosted the rate of GDP growth by close to 2 percentage points. The International Monetary Fund (IMF) was also supporting

Table 3: The effectiveness of adjustment lending

Period/ dependent variable	*Change in rate[1] of growth of GDP (%)*	*Change in investment/GDP (%)*	*Change in domestic saving/ GDP (%)*	*Change in export/GDP (%)*
Current prices				
1985-88 with 1970-80	1.3	-4.1**	4.0***	6.4**
1985-88 with 1981-84	2.0***	0.5	4.2*	5.0***
Constant prices				
1985-88 with 1970-80	1.0	-5.6**	2.0	1.2
1985-88 with 1981-84	1.9****	-0.1	5.8*	2.3

1. The rate of growth of GDP is measured at constant prices in both cases but the estimation procedure requires the use of lagged values of all the performance indicators and that is the reason for slightly different estimation of the effect of programs on rate of growth of GDP in the top and bottom of the table.

* Statistically significant at the 2.5% level.
** Statistically significant at the 5% level.
*** Statistically significant at the 7.5% level.
**** Statistically significant at the 10% level.

most of these programs. However, the results of effectiveness of Bank supported programs are already adjusted for the presence of an IMF program.[5] Typically, growth under the successful adjustment programs usually improved the growth rate as a result of higher export growth, which more than offset the contractionary effects of the reform policies. The less successful programs did not shift resources rapidly enough from nontradable to tradable activities to increase growth, probably because of market distortions and institutional weaknesses. In some countries with severe macroeconomic instability, the programs supported by the initial adjustment loans broke down, a situation that depressed growth in 1985-88.

In the case of investment, after adjusting for other factors, the adjustment programs appear to have led to a drop in the investment share in GDP (in current prices) of 4.1 percentage points between 1970-80 and 1985-88. The decreases between 1981-84 and 1985-88 were small and not statistically significant. Further, because most EIAL countries carried out a real depreciation in 1985-88, the relative price of investment goods rose. As a result, the effect of the programs was an even larger average reduction -- 5.6 percentage points of GDP -- in the constant price ratio of investment to GDP between 1970-80 and 1985-88. Finally, as compared with other countries, the different statistical techniques all show that countries with adjustment programs had lower ratios of investment to GDP. This decline came not only from lower public investment, but from lower private investment, probably caused in part by the greater economic uncertainty at the start of the adjustment program.

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[5] The adjustment is made by introducing a dummy variable that takes the value of one for countries with IMF programs and zero, otherwise.

The reduction in the rate of private investment may have been unavoidable in the initial phase of the adjustment programs (see Section IV). Under pressure to reduce public sector deficits, many governments substantially reduced their investment programs (and current expenditures for the maintenance of infrastructure) because of their incapacity to reduce other expenditures. However, such reductions in public investment in infrastructure and human capital seriously jeopardized the resumption of private investment and the ultimate success of the adjustment programs. On the other hand, expansion of efficient public investment enhances the supply response to the reformed incentive structure by increasing the credibility of the adjustment programs and thus contributing to the expansion of private investment.

A decline in investment is worrisome, since in most countries sustainable higher growth is likely to require an increase in investment above the average levels of the 1980s. The hoped-for recovery of investment to sustain future growth did not occur in most EIAL countries, although their experience varies (Table 4). At the same time, the impact of the programs on investment should be viewed with caution. Since adjustment is not estimated to have reduced growth, it must have increased the average efficiency of capital. Where an integral aim of the adjustment programs was to curtail public (and private) investment programs whose efficiency was low, a decrease in the rate of investment was part of the adjustment.

With respect to the domestic saving rate in current prices, after adjusting for the effects of other factors, it increased more in the EIAL countries than in other countries (Table 3). (The domestic saving rate is more appropriate than the national saving rate for measuring the impact of adjustment on resource mobilization, because net factor payments abroad are

Table 4: Country differences in performance

	Leading performers	Lagging underperformers
Change in annual average rate of GDP growth, 1985-88 compared with 1970-80		
	Korea	Nigeria
	Mauritius	Philippines
	Morocco	Malawi
	Ghana	Côte d'Ivoire
	Thailand	Mexico
Saving rate in current prices, 1985-88 compared with 1970-80		
	Korea	Nigeria
	Chile	Zambia
	Costa Rica	Malawi
	Jamaica	Philippines
	Mauritius	Senegal
Investment rate in current prices, 1985-88 compared with 1970-80		
	Costa Rica	Côte d'Ivoire
	Korea	Malawi
	Jamaica	Nigeria
	Chile	Zambia
	Kenya	Philippines
Investment rate in constant prices, 1985-88 compared with 1970-80		
	Korea	Malawi
	Mauritania	Zambia
	Mauritius	Nigeria
	Togo	Côte d'Ivoire
	Madagascar	Philippines
Export-to-GDP ratio in current prices, 1985-88 compared with 1970-80		
	Jamaica	Kenya
	Mauritius	Senegal
	Chile	Malawi
	Korea	Zambia
	Mauritania	Brazil
Export-to-GDP ratio in constant prices, 1985-88 compared with 1970-80		
	Jamaica	Kenya
	Mauritania	Zambia
	Korea	Nigeria
	Togo	Madagascar
	Mauritius	Malawi

not deducted and net foreign transfers are not included.)[6] As a share of GDP, the domestic saving rate rose about 4 percentage points more for the EIAL countries than for the other countries, whether using 1970-80 or 1981-84 as the base period.

With respect to the ratio of exports to GDP in current prices, after adjusting for other factors the Bank-supported programs had a positive effect, boosting it about 6.4 percentage points of GDP between 1970-80 and 1985-88 and 5.0 percentage points between 1985-88, although with large differences across countries. The strong positive effect of the programs on the ratio of exports to GDP in current prices could be in part the result of the accounting effect of real devaluations by the EIAL countries in the third period. As to the ratio of exports to GDP in constant prices after controlling for other factors, the adjustment programs on average had a positive, although not statistically significant, effect (Table 3).

The low and statistically insignificant effect on the ratio of exports to GDP in constant prices raises concerns about the speed of the supply response of exports to the changed incentives brought about by a real devaluation. The small and slow average response may be accounted for by the absence of the investment needed to increase supply and by uncertainties about the stability of the improved incentives for exports. For countries with a long history of macroeconomic instability, with discrimination against

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[6] The effect of the programs on the national saving rate is also positive but is statistically significant at the 5 percent level only when comparing performance in 1981-84 with 1985-88.

exports, and with unstable real exchange rates, the export response would be low.[7]

In terms of the ratio of imports to GDP in current prices, the structural adjustment programs in the EIAL countries had a small negative effect of 1.7 percentage points from 1970-80 to 1985-88, and a small positive effect of 1.3 percentage points from 1981-84 to 1985-88.[8] Given that in some countries output has been constrained by a lack of imports, the improved access to imported inputs may in part have led to the increase in the efficiency of investment between 1981-84 and 1985-88 by permitting fuller use of productive capacity.

The macroeconomic performance of intensive-adjustment-lending countries has thus been at least adequate on the dimensions of GDP growth, saving, exports, and imports, with the very strong performance of some countries more than making up for the declines witnessed in others. In the area of investment, however, aggregate performance has been poor. Behind this average results there are important differences across countries. Table 4 reports result of country performance for each indicator after adjusting for other facts.

B. The Effectiveness of Adjustment Programs--Social Welfare Indicators

Aggregate economic performance does not tell the whole story of the effect of structural adjustment. It is important also to consider what

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[7] On the role of incentives and uncertainty on exports, see R. Caballero and V. Corbo, (1989).

[8] This result comes from the identity that investment minus saving equals imports minus exports.

happened to indicators of consumption, especially by the poorest level of society, and what happened in the education and health sectors.

In countries with an unsustainable current account deficit, the macroeconomic component of the adjustment programs encourages a reduction in aggregate demand, generally through monetary and fiscal restraint. It also encourages switching production from the nontradable to the tradable sectors, generally through a real devaluation. The reductions in aggregate demand are likely to have negative short-run effects on the growth of output and employment. On the other hand, the structural reforms (economy-wide and sector-specific) improve the efficiency of the economy, have a longer term positive impact on the growth of output, and are likely to reduce poverty in the medium to longer run. That is, while the reduction in aggregate demand and the structural reforms are bound to have distributional consequences, the potential adverse short-run effects must be weighed against the longer run benefits.

In countries with high inflation, policies that permanently reduce the fiscal deficit make a major contribution to the reduction of inflation. Lower inflation should help the poor, who are less able to protect the real value of their assets and incomes from inflation. Lowering the fiscal deficit requires a combination of revenue increases and expenditure cuts. On the revenue side, higher income taxes generally do not affect the poor, and the goods they consume can be exempted from excise taxes. As to expenditures, whether the decreases will affect the poor depends on the incidence of the cuts. For example, reductions in health spending could have a negative impact. If, however, the composition of health expenditures were to switch toward preventive medicine and away from curative medicine, which goes mainly to the middle class, the impact on the poor could be softened.

As to structural reforms, changes in relative prices that remove the biases against labor should help reduce poverty in the long run. Devaluation of the exchange rate will help the poor if they produce tradable goods and will hurt them if they consume tradable goods, such as imported necessities. Removal of the ceilings on agricultural prices will benefit the rural poor, who are net producers of food, but hurt the urban poor, who are net consumers of food.

It is difficult to assess the effects of adjustment programs on the poor for three reasons. First, it is inherently difficult to establish causality -- to isolate the effects of adjustment programs from other factors -- and particularly to determine whether alternative policies would have done better or worse. Second, socioeconomic data on the living conditions of the poor are scarce and often of dubious quality. Although many of the poor work in the informal sector, data on the output of that sector and on other variables are usually not included in official statistics. Third, adjustment programs are relatively new, and their long-run positive effects probably take longer than the experience with adjustment so far.

At the same time, while a complete analysis of adjustment programs must await the conclusion of the entire adjustment period, interim evaluations such as those here are still necessary.[9] In general, the limited cross-sectional data on changes in poverty do not suggest that adjustment lending has on average increased poverty. Furthermore, aggregate data support similar conclusions:

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[9] The central topic of World Development Report 1990, World Bank (1990) is poverty. This report includes additional analyses of the impact of adjustment programs on poverty.

- On average, the rate of growth of private consumption in the EIAL countries recovered in the late 1980s to the rate achieved in the 1970s -- and the rate in the late 1980s was higher in total and on a per capita basis in comparison with other groups of countries.
- The socioeconomic indicators of the status of the poor in developing countries or in the EIAL group did not deteriorate in the 1980s on average. The indicators of nutrition improved, and average protein intake continued to rise from 1983-84 to 1986 in all categories of countries, with and without adjustment lending. Infant and child mortality, indicators of the longer run health status of the poor, continued to improve on average for country categories with and without adjustment lending.
- Data on health and education point to the deterioration of the situation of the poor. The shares of central government expenditures for health and education declined on average in the EIAL countries having data. Some of the decline may have occurred because better targeting of public expenditures left middle- and upper-income groups paying for more of the provision of these services or because other levels of government took responsibility for some of these expenditures. In education, there were declining rates of primary school enrollment for the EIAL countries. This trend is inconsistent with restoring sustainable long-term growth, which requires strengthening the human capital base, an important input in growth. In health, the coverage of immunization generally increased in all country groups, a trend that probably accounts for much of the continuing decline in the rates of infant and child mortality.

C. Program Implementation

The data set on conditionality and implementation, with a much expanded sample of loans approved in FY79-88, showed most of the same patterns found in the first Report, and revealed some new ones (Webb and Shariff, 1990). Countries begin implementing their structural adjustment program before the adjustment loans become effective and frequently continue implementation after disbursement ends. Progress in implementation is measured by the share of conditions in the loan agreements that have been implemented by the time of final tranche release. Of all conditions in the loan agreements in the sample, 84 percent had been implemented at least substantially -- better than found in the first Report -- and 66 percent had beeen implemented fully or more than fully by the time of final tranche release.

Implementation rates increased during the 1980s, both for countries that had received adjustment loans since the early 1980s and for countries that started more recently. For the loans in the sample that had final tranche release in FY89, i.e., since the first Report, 99 percent of the conditions were implemented at least substantially, and 80 percent of the conditions as originally written were implemented fully or more. In the rare cases when a condition as originally written does not seem necessary, the Bank waives the condition, with approval from the Board. Not counting the one loan in the sample for which this occurred in FY89, this would raise the proportion of fully implemented conditions from 80 to 88 percent. Thus, the final tranches were released only when all conditions in the loans were at least substantially fulfilled. Implementation rates are lower for countries with higher rate of inflation. This finding illustrates the importance of macroeconomic stability once again.

Governments have been more frequently able to develop and maintain political support for structural adjustment when the program was designed with this aim in mind and when the government was active in explaining the source of the problems addressed by the program, how it planned to tackle them, why this was the best option, and how people would benefit from the new policy environment. Mobilizing beneficiaries to become political supporters usually follows. While technical considerations sometimes cause unavoidable delays in program implementation, more prompt implementation almost always increases the chances of political support. Awareness of the economic problems that motivated the initial decision for reform will be strongest at the beginning, giving the authorities maximum latitude for reform. The support for sustaining the new status quo then develops as structural reform pays off in growth and higher living standards.

Although adjustment programs often call for a reduction of resources going into the public sector, it is equally important to strengthen public institutions through improved policies, organization, and management. Institutional development is essential for both the implementation and the ultimate success of many of the reforms the Bank supports.

IV. MAIN RESULTS OF RAL-2: POLICIES THAT PROMOTE GROWTH

The Report on Adjustment Lending - II not only evaluated the effectiveness of adjustment lending in the past, but also provided a summary of the relevant research on what policies promote sustainable growth. The policies to increase investment, saving, and the rate of increase of efficiency would, of course, be prime candidates for inclusion in structural adjustment programs.

In theory, adjustment measures should boost investment, particularly in the tradable goods sector. The increase in investment will provide a connection between adjustment, growth, and external balance that will ensure the sustainability of the adjustment effort. The reason, of course, is that structural adjustment programs change an economy's incentives to increase efficiency and encourage growth. Given the pivotal role of increased investment in the recovery of sustained growth, adjusting countries will need to institute further policy reforms in the later phases of adjustment to restore adequate levels of investment. This section looks at why adjustment programs have constrained investment and then suggests further policy reforms adjusting countries will need to make to achieve sustainable growth. Specifically, they must address the uncertainty and lack of credibility that often accompany adjustment programs and deter investors, they must foster higher rates of saving by both the public and private sectors, and they must increase the efficiency of investment by removing distortions.

A. Increasing Investment

To understand what policies are needed to increase investment, it is useful to understand why it declined so frequently during adjustment. One reason for the slow investment response to structural adjustment programs is investor uncertainty about governments' commitment to carry the programs through. That is, the adjustment programs lacked credibility. Private agents may also receive mixed incentive signals -- some associated with the previous policy rules, some with the stabilization package, and some with the structural reforms aimed at restoring medium-term growth. This uncertainty about the future economic environment, particularly the incentive structure, leaves investors reluctant to make fixed investments, as for the most part

they are irreversible; capital, once installed, can seldom be put to productive uses in a different activity, at least not without incurring a substantial cost. Thus, a trade reform that is suspected of being only temporary can reduce investment, as economic agents postpone their investment decisions while waiting to see whether the reform lasts (Serven and Solimano, 1990).

The opposite is also true, however; investment may be furthered by a stable and predictable incentive structure and macroeconomic policies, even more so than by tax incentives or subsidized interest rates. Under conditions of great economic and political uncertainty, making tax and related incentives high enough to have any significant impact on investment is usually prohibitively expensive.[10] In Argentina, Honduras, Morocco, and even Turkey, investment incentives substantially enlarged government deficits without appreciably increasing investment.

Investment also declined because of the reduced availability of financing. Lower external financing forced an important decline in the deficit in the resource balance -- defined as the difference between domestic investment and domestic saving -- following the debt crisis in 1982 (Table 5). Because this decline was not matched by a sufficient increase in domestic saving, the deficit was almost entirely reflected in reduced investment.

The demand for investment fell for several reasons. For one, public investment contracted because in some cases it was unsustainably high and of dubious productivity. Other reasons were the deterioration in fiscal conditions as a result of the cut in foreign lending and the lack of adjustment in other fiscal expenditures, the rise in international and

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[10] See R. Pindyck (1989).

domestic interest rates, and the sharp acceleration of inflation, which eroded real tax receipts. In the case of private investment, slower or even negative growth discouraged it in several countries, as did the adverse external shocks, the uncertainty about the new configuration of relative prices and incentives, and the inability of governments to stabilize their economies. In addition, the debt overhang may have discouraged investment not only through the uncertainty it created but also through its implicit "tax" on future output and the resultant credit rationing in the international capital markets.

Uncertainty and lack of credibility often undermine the effectiveness of macroeconomic policy. There are two aspects to credibility: the internal consistency of the adjustment program; and the government's commitment to carry it out despite possible short-run costs. When credibility is low, and the investment response is therefore insufficient to restore growth, a structural adjustment program may entail larger-than-anticipated social and economic costs.[11] A persistent slump may develop before investors become confident that the adjustment measures will be maintained. Resolving the problem of a low investment response may be particularly critical for economies with a history of frequent policy swings or failed stabilization attempts. As the recent experiences of Bolivia and Mexico show, while establishing the right economic incentives is a precondition for investment and growth, it cannot guarantee them.[12]

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[11] Credibility introduces an externality that creates a wedge between the social and private returns on investment. In fact, higher aggregate investment helps sustain the adjustment and therefore results in higher returns on investment. However, the individual investor will ignore this mechanism.

[12] See R. Dornbusch (1989).

Any assessment of credibility and uncertainty should influence the choice between gradual and abrupt adjustment. Under gradual adjustment, the initial objectives are modest ones that can be achieved with near certainty, so that the government can build its reputation. However, gradual adjustment may build up resistance to change. Abrupt adjustment starts with an overadjustment -- say, an overdepreciation of the exchange rate accompanied by large cuts in tariffs -- the aim being to frontload the incentives for resource reallocation. However, this approach also concentrates the costs of the adjustment.[13] The choice appears to depend largely on the specifics of each country, with the social distribution of the adjustment costs and policy experience likely to be important factors.

Sufficient external support for the adjustment effort of a committed government can raise the confidence of investors in the sustainability of the adjustment and thus enhance the takeoff of investment. Implementation of well-targeted public investment projects that attract private investment may be another important element in getting growth under way.

The implementation of well-targeted public investment projects in infrastructure which complement, rather than compete with private investment can get growth under way by attracting private investment. Institutional reforms and the correction of microeconomic distortions can also play an important role in the recovery of investment by facilitating the private sector's access to factor and financial markets, improving its entrepreneurial

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[13] On these topics, see M. Kiguel and N. Liviatan (1988); and A. Solimano (1990).

capabilities, and making the legal and regulatory framework more conducive for business.[14]

B. Increasing Saving

To sustain investment for a desirable rate of growth, the adjusting countries have to increase their rate of saving. This need is greatest in the highly indebted countries, mostly in Latin America and in Sub-Saharan Africa, whose saving rates fell significantly in the 1980s (Table 5).

Although public policies can affect public saving directly, there are limits to their effect on private saving. Public saving and the way it is financed affect the economic environment -- GDP growth and inflation -- and

Table 5: Gross domestic and national saving ratios in 83 developing countries

Indicator/region	*1970-80*	*1981-84*	*1985-88*[a]
Gross domestic saving/GDP			
Total	0.15	0.12	0.13
Africa	0.11	0.06	0.08
Asia	0.19	0.19	0.21
Europe/Middle East/ North Africa	0.15	0.16	0.15
Latin America and Caribbean	0.20	0.17	0.17
Gross national saving/GNP			
Total	0.14	0.10	0.10
Africa	0.11	0.06	0.06
Asia	0.18	0.18	0.19
Europe/Middle East/ North Africa	0.15	0.14	0.12
Latin America and Caribbean	0.17	0.12	0.11

Note: Data were not available for Guinea, Hungary, Mozambique, Poland, and Yemen PDR.
a. In a few cases, 1988 data were unavailable; for them, the 1987 saving ratios were assumed.
Source: ANDREX database, World Bank

[14] For a thorough discussion of these issues, see World Bank (1989a); see also G.M. Meier and W.F. Steel, eds., (1989).

this environment in turn affects decisions on private saving. That is, public and private saving, although analyzed separately here, are closely linked.

To measure public saving properly requires defining the public sector comprehensively as encompassing central and local governments, financial and nonfinancial public enterprises, and the quasi-fiscal operations of the central bank. In many countries, the losses of public enterprises have contributed to the high public deficits. In Bolivia, public enterprise deficits reached 5 percent of GDP before the 1987 stabilization. In Argentina, they have fluctuated between 2 percent and 7 percent since the early 1980s. In Zimbabwe, they were reduced from 9 percent of GDP in 1982 to 4 percent in 1988. In some countries, the losses of the central bank have been even more important than the deficit of the general government or the public enterprises. Often these losses have resulted from quasi-fiscal operations such as emergency loans at subsidized rates to failing domestic financial systems and from foreign exchange subsidies to domestic holders of foreign debt. In Argentina the central bank's losses have fluctuated between 2 percent and 6 percent of GDP since 1982, while in Chile they were 7 percent of GDP in 1985 and in Venezuela 6 percent of GDP in 1987.[15]

Changes in the public sector deficit and in public saving result not only from the direct effects of tax and expenditure policies but also from the interaction of fiscal policy with other policies and with foreign economic shocks.[16] For example, depreciation of the exchange rate affects all budget items that are fixed in foreign currencies or indexed to world prices. A real

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[15] V. Corbo and K. Schmidt-Hebbel (forthcoming).

[16] Public saving and the deficit are directly linked: the public deficit is defined as public investment minus public saving.

depreciation increases the budget deficit (relative to GDP) when the public sector has more expenses than revenues denominated in foreign currencies -- as in countries where the foreign debt service is a large part of public spending (e.g., Brazil, Philippines, and Turkey). In countries where the public sector obtains much revenue from import taxes or commodity exports -- oil in Mexico, phosphates in Morocco, and copper in Zambia -- a real depreciation tends to decrease the budget deficit.

In most countries the bulk of saving is accounted for by the private sector. While government policy can readily alter the disposable income of the private sector, in a market economy it has only limited influence on the share of disposable income that the private sector saves. Key policies that affect private saving are the rate of return on saving, the level and form of taxation, the rate of inflation, the real exchange rate, the flight of capital, the business cycle, the inflows of foreign capital, and the rate of growth (Table 6).

Credit rationing and controls on interest rates discourage saving in many countries. The low or negative real interest rates on deposits and targeted credits reduce the supply of loanable funds and hence effectively ration investment.[17] Financial reforms that raise real interest rates to market clearing levels are justified because they improve the efficiency of resource use, which boosts long-run growth.[18] The effect of higher real interest rates on the level of private saving is ambiguous, however. The

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[17] For a recent review of financial systems and financial liberalization in developing countries, see World Bank (1989b).

[18] This policy prescription is taken from R. McKinnon (1973); and E.S. Shaw (1973).

Table 6: Public policy and private saving: effects of intervening variables

	Inflation and relative price stability	*After-tax real rate of return on saving*	*Per capita disp. income*			*Foreign resource constraint*	*Income concentrat.*	*Capital flight*	*Total effect on saving*
			Growth	*Trend*	*Deviation from trend*				
Effect of an increase in intervening variable on private saving	-	+	+	+	+	-	+	-	
Policy									
Financial liberalization		?		+ (L.run)			+		+ ? (L. run)
Fiscal/monetary stabilization	+	?		+ (L.run)	+ (L.run)	- (S.run)			+ (L. run)
Selective tax incentives on particular financial assets		+ ?							+
Shift of taxation from corporations to households							+		+
Shift of taxation from higher to lower income households							+		+
Shift from income to consumption tax		?					+		+
Real exchange rate depreciation			+ (L.run)		- (S.run)			+	+ (L. run)
Foreign capital inflows			+ (L.run)		-				

Note: The signs in the first line indicate the effect of the intervening variable on private saving, while the signs in the remainder of the table denote the fiscal effect of each policy through the corresponding intervening variable. For detailed discussion of the effects, see text.

reason is that an increase in the real return on saving has two offsetting effects. First, a higher real interest rate decreases the present cost of future consumption, so that it is attractive to consume less now and more in the future and thus to save more today. Second, it is no longer necessary to save as much to achieve a target level of future consumption. A higher real interest rate therefore allows greater consumption both today and tomorrow and reduces the need to save today.

Given this theoretical ambiguity, the effect of the real interest rate on saving becomes an empirical issue. A large body of evidence for both

industrial and developing countries shows that, on average, real interest rates or after-tax real rates of return do not have a significant effect on the share of private income that is saved.[19] However, financial liberalization that allows real interest rates to rebound from very negative to near-zero levels often has a positive impact on measured private saving in financially unstable, high-inflation countries. This effect is attributable to reduced flight into consumer durables and foreign assets after the interest rate has risen.

Public policies to raise public saving and hence national saving have a key role in structural adjustment. The evidence shows that the private sector does not reduce its saving one-for-one with tax increases or public spending cuts; it follows that reductions in budget deficits increase national saving. This fact has profound implications for Bank-supported adjustment lending. It was concluded earlier in Section III that after controlling for the effect of other factors, the domestic saving rate rose 4 percentage points more in EIAL countries than in any other group of countries. Thus, adjustment programs supported by the Bank have played a significant role in raising aggregate domestic saving and changing its composition in favor of public saving.

C. Increasing Investment Efficiency

Resources for investment are scarce, and it is therefore vital to increase the efficiency of investment. Further, because more efficient investment has a higher rate of return, increasing the efficiency of

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[19] Among the studies presenting growing evidence on the interest insensitivity of saving in developing countries see, for instance, A. Giovannini, (1985). For an alternative view, see M.J. Fry (1988), and the survey by B. Balassa (1989).

investment encourages savings to stay in the developing economy and not to go into capital flight.

Investment is more efficient with relatively nondistortionary policies, and therefore policy changes that reduce the distortions in resource allocation not only raise the baseline level of efficiency but also tend to raise growth in the long term. The size of the initial distortions and the magnitude of the reduction affect how much growth will respond. Growth-enhancing policies include lowering tariffs, relaxing import quotas, raising or decontrolling domestic interest rates, reducing reserve requirements or mandatory government bondholdings, reducing government subsidies for consumption or production of particular goods, and reforming taxes to reduce or eliminate differential treatment of sectors or inputs.

Reforms to improve incentives can proceed in several steps. For example, tariffs can initially be substituted for quotas, both to increase the transparency of incentives and to raise public revenue. Later, tariffs can be reduced as other revenue sources are expanded. Institutional development may be necessary to strengthen the private responses to such changes in incentives. In low-income countries, the lack of well-developed public and private institutions may be an important hindrance to growth even if trade and financial incentives are not distorted. A stable system of civil liberties, well-defined property and contractual rights, and predictable and equitable regulation are widely believed to be particularly important in harnessing the energies of entrepreneurs in Africa.[20] A comparison of the long-run growth experience among many developing countries concluded that govenments' administrative competence was the single most important factor explaining the

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[20] World Bank (1989b).

differences in growth.[21] Political stability and the safeguarding of civil liberties have also been found to increase growth.[22]

An important finding of our research is that the largest payoff comes from changing high distortions into low ones. Neither a small reduction in high distortions nor the complete removal of small distortions does much to foster higher growth in the long run, a conclusion that is based on examination of country experience and simulation of a structural model of growth. Since policymakers have only a limited amount of political capital for correcting distortions, they should concentrate their efforts on the changes that have the largest payoff in increased growth rates. If more than one major distortion exists, all should be reduced together.

V. LESSONS FOR EASTERN EUROPE OF OTHER REFORM EXPERIENCES

In this section we draw some lessons for the design of programs in Eastern Europe from the experience with adjustment program elsewhere. The evidence that we use is drawn from both successful and unsuccessful reforms.

Although initial conditions are not the same in all the Eastern European countries, some common elements exist. At the cost of simplification the general characteristics are the following: (1) large excess demand at existing prices. This is especially the case in Bulgaria, Romania, and until recently in Poland. Excess demand is less severe in Czechoslovakia, Hungary, and Yugoslavia. (2) large external debt and unsustainable balance of payments situation, with the exception of Romania and Czechoslovakia. A large part of

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[21] G. Lloyd Reynolds (1985).

[22] R. C. Kormendi and P. G. Mcguire (1985); Gerald Scully (June 1988).

their international trade takes place at non-market terms. (3) At the structural level most of the countries have a structure of industry, dominated by large state enterprises, that is uncompetitive at international prices; they lack labor, land and financial markets, and the whole set of institutions needed to support a market economy (especially appropriate accounting procedures, property rights, bankruptcy laws, and commercial law). However, Eastern European countries have the big advantage that they start with a very good human capital base, are next to one of the most dynamic international markets (Western Europe), and have a privileged political relation with the Western European governments.[23]

For countries that start with acute macroeconomic imbalances in the form of high open or repressed inflation and/or unsustainable current account deficits, stabilization has to be initiated at the beginning of the adjustment program. For countries with a history of increasingly binding price controls, stabilization has two components; first, the elimination of the money overhang (a stock problem) and second the elimination of the public sector deficit (a flow problem). The elimination of the money overhang can be done through a once and for all increase in the price level or through a monetary reform. Coming out of World War II most European countries used the route of monetary reform to get rid of the monetary overhang (Dornbusch and Wolf 1990). However, most of the post 1950's experience has been focused on the elimination of the money overhand through an increase of the price level.

Countries with a large money overhand run the risk that the initial increase in the price level could result in a protracted period of high inflation. Even after taking care of the fiscal adjustment, some countries

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[23] For a good description of the initial conditions in the Eastern European countries, including social and political factors, see Lipton and Sachs (1990).

have found it very difficult to contain the inflation dynamic that usually develops following the initial increase in the price level. For example, Chile liberalized prices in 1973, however in spite of reaching a public sector surplus by 1975, three digit inflation lasted until 1977 (Corbo and Solimano, 1990). Most of the expenditure reduction has to be done through fiscal policy as monetary policy does not have much of a role in countries without capital markets and where the main borrowers are public enterprises without a hard budget constraint (Chile 1973, Mexico 1983, Egypt 1990).

In countries where there is limited flexibility in the labor market, to break the inflation inertia that could follow the liberalization of prices, the drastic reduction in the public sector deficit needs to be followed by some kind of income policy.[24] This was the route followed by Israel in 1985, Mexico in 1987 and Poland in 1990. To avoid a prolonged period of inflation, a permanent reduction in the public sector deficit should be done early on in the reform process. A permanent reduction in the public sector deficit requires the imposition of a hard budget constraint on public enterprises, a drastic reduction in public sector subsidies, and the creation of an efficient tax system. A negative lesson is to avoid the temptation of using only the nominal exchange rate to bring a stubborn inflation under control. The real appreciation that could develop could put in jeopardy the full reform effort (as in Chile in 1978-1982, Mexico in 1988-89, Israel in 1986-88, Argentina in 1978-80, Uruguay in 1980-1982).

Socialist countries in transition to a market economy and heavy regulated economies in Africa and in countries like Turkey (1980), Chile (1973), Mexico

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[24] Inertia can result also from lack of credibility or lagged indexation schemes. The latter form of inertia played a central role in the slow pace of inflation deceleration of Chile in 1978-1982 (Corbo, 1985).

(1982), also face the problem of how to reduce large distortions in relative prices, as well as the distortions resulting from heavily regulated or almost non-existing labor and financial markets. On top of these distortions, there exists the additional burden of a large public enterprise sector with low response to price incentives, and a lack of institutions to manage macroeconomic policies and establish a minimum set of rules for the normal functioning of a market economy (i.e. property rights, bankruptcy laws, appropriate accounting procedures etc.).

For a country that is about to initiate a major reform effort, the question that has to be faced from the beginning is the sequence and speed of other reforms. Any reform that calls for a major reallocation of resources will need to deal with appropriate and credible relative prices early on. In countries that have much to gain from an integration in the world economy, like Mexico (1982), Chile (1973) and the Eastern European countries today, trade reforms have a very high priority. The initial stages of a trade reform, such as the replacement of managed trade by open trade, the replacement of QR's for tariffs, and the reduction of extreme tariffs, should be attempted early in the reform process. However, major trade liberalization should be attempted only when clear and credible progress has been achieved in reducing inflation or when there is a clear perceived commitment from the authorities that the anti-inflationary program has a very high priority. In countries with a very uncompetitive domestic economy, trade liberalization may help the stabilization effort, as could be the case of Mexico (1988) and Poland (1990), however, a major fiscal adjustment is necessary to generate appropriate spending reduction and to avoid a balance of payments crisis.

Trade reforms aim to shift investment and labor from nontradable and highly protected import competing activities toward the export oriented and

efficient import-competing activities. But unpredictable relative prices (as is usually the case in high inflation economies), lack of labor mobility, lack of financial markets, and impediments to the creation of enterprises are major roadblocks to a successful trade reform. Therefore in many of the Eastern European countries privatization and the emergence of new private firms could be an important component of the economic restructuring program.

A major study of trade liberalization (Choksi, Michaely and Papageorgiou 1990) found that countries that carried out and sustained trade reforms usually had lower fiscal deficits and inflation than countries where liberalization failed. In some cases, successful trade liberalization was carried out while stabilization was still under way--as in Chile in 1974-79 and Turkey in 1980-84. In more typical cases, either severe macroeconomic instability contributed to the failure of the stabilization (Argentina, Brazil and Sri-Lanka in the 1960's, and Peru, Philippines, Portugal, Turkey, and Uruguay in the 1970's) or stability contributed to successful liberalization (Greece, Korea, and Spain plus all of Western Europe).

Internal reforms have also been important determinants of the success or failure of trade liberalization attempts. The lack of labor mobility (including restrictions on labor reallocation within a firm and the requirements for high severance payments), restrictions to entry and expansion of firms, as well as restrictions to exits of firms (including distress financing to firms that are and will never be profitable at the new undistorted relative prices), could severely reduced the benefits of trade liberalization and even put the whole reform effort in jeopardy. Lack of incentives or regulations that slow down or make it costly for firms to restructure or shut down have been an important factor in failed or costly liberalization attempts in Poland, Hungary, Turkey (in the 1970's), and

Yugoslavia. In contrast, deregulation of the labor market played an important role in the success of the trade reforms in Chile (World Bank 1990a). Domestic regulatory policies that restricted factor and output mobility, including restrictions to the entry and exit of firms, increased the adjustment costs to the trade reforms in Mexico and Morocco.

Conclusions

Based on growing evidence from failed and successful reforms we conclude that:

(1) High open or repressed inflation and other manifestations of severe macroeconomic imbalances, such as unsustainable current account deficits or very large positive real interest rates, need to be tackled at the beginning of an adjustment program.

(2) Restrictions to labor mobility and to the exit and entry of firms should be removed at roughly the same pace as trade is being liberalized so that reforms can achieve an increase in output early on rather than cause unemployment.

(3) The creation of a full fledged financial system should wait until the stabilization is well consolidated; however, markets for working capital financing with appropriate mechanisms to assess credit risks should be created early on to facilitate the economic restructuring.

(4) Institution-building including the capacity to formulate and execute macroeconomic policies and the regulatory framework for the appropriate function of markets are important complements to successful reforms.

The road to reforms is a difficult one but the alternative of perpetual stagnation and deteriorating living standards is even worse. Reforms such as

the ones being initiated today in Eastern Europe do not have much precedent in recent economic history, but from the evidence that we have reviewed one can conclude that most likely output levels will suffer in the early years of massive economic restructuring. However, it will be very important for the governments to beware of these adjustment costs as they represent investment in a better economic system. To make this investment highly profitable they will need to stick to their policies and to remove impediments to factor reallocation. As the credibility on the reforms start to build up, the investment and output response will materialize. The road to reforms in Latin-America is littered with failures that arise from the incapacity to achieve and maintain macroeconomic balances and/or the abandonment of well-intended reform efforts when some of the short-term, unavoidable costs started to appear. The reforms in Chile in the 1970s and in Mexico in the 1980s took a long time to put the countries on sustainable growth paths. Improvements on the record of these two countries can be obtained by addressing some of the issues raised in this paper and reform oriented governments should be prepared to sell and sustain programs that will take 2 or 3 years before starting to reflect the fruits of the reforms by way of output levels. In the short run, access to external financing in support of the adjustment effort could help to achieve consumption levels higher and to finance part of the investment needed in the activities that are suppose to expand as a consequence of the reforms.

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